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IN THE

Supreme Court of the United States

October Term, 1973
No. 73-247

LAWRENCE HOLZMAN, Trustee in Bankruptcy,
Petitioner,

vs.

L.H.J. ENTERPRISES, INC.,
Respondent.

REPLY BY PETITIONER TO RESPONSE FILED BY RESPONDENT.

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To the Honorable Members of the United States Supreme Court:

The Respondent has now filed its response to the petition for the Writ of Certiorari. By that response it disputes none of the facts and indeed none of the law as asserted by petitioner. Instead Respondent says merely that the grounds here urged by petitioner for the writ were not heretofore raised in the Court below. The Respondent is in error. The Petition for Rehearing filed by petitioner in the Ninth Circuit Court of Appeals (a copy of which is hereunto annexed) contained the same three questions, substantially, as are now urged here for the granting of the writ. Furthermore the one case cited by respondent *i.e., Hormel v. Helvering,* 312 U.S. 552 (1941), appears to be opposed to Respondent's argument here. (See particularly the opinion of Mr. Justice Black for the Court at page 557.)

None of the circumstances justifying the application of the doctrine asserted by respondent is present here because substantially the same three questions herein were in fact raised in the Circuit Court, and they are raised, and their merits are exhibited, in the petition for certiorari and none has ever been expressly waived. The petition for certiorari makes clear the miscarriage of justice that would result if this Court does not consider the questions here presented.

We submit that for all the reasons set forth in the petition, that the Writ of Certiorari should issue, or that the decision below should now be reversed on the record here made.

Respectfully submitted,

CHARLES J. KATZ,
By CHARLES J. KATZ,
Attorney for Petitioner.

KATZ, HOYT & BELL,
LUCE, FORWARD, HAMILTON &
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Of Counsel.

APPENDIX.

No. 72-1208

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

LAWRENCE HOLZMAN, Trustee in Bankruptcy,

Appellant,

vs.

L.H.J. ENTERPRISES, INC.,

Appellee.

---

1. Petition for Rehearing.
2. Suggestion That Cause Be Heard En Banc.

Prefatory Statement.

The decision here made upholds as valid against a trustee in bankruptcy, a general roving purchase money security interest upon the proceeds of the future acquired inventory of a retail merchant; and, it does so in the setting of a filed financing statement which does *not* disclose upon its face that a lien upon the proceeds of any such future acquired inventory is claimed by the secured party.

Because of its broadly pervasive effect upon both commercial and bankruptcy law, and its potential for clash with the due process clause of the Federal Constitution, it is respectfully suggested that if there be a rehearing ordered, that then it be reheard en Banc.

The case was heard and reviewed on a stipulation of facts and involves purely questions of State Commercial and Bankruptcy Law.

Grounds for Rehearing.

I.

The financing statement as filed here expressly *does not cover* the proceeds of the after acquired collateral (and expressly *does not even cover the proceeds* of the original collateral); it is thus violative of the standard established by Commercial Code 9402 for financing statements.

II.

The purchase money security interest exemption from the statutory prohibition (Commercial Code 9102 (4)) against inventory liens of a retail merchant in California, means a *purchase money security interest in the inventory of a retailer which is actually sold (or specifically financed by the secured party) to that retailer.* As a *purchase money* security interest, it does not mean, for it cannot by its own terms mean, a purchase money security interest in the goods sold to the retailer by third party vendors, such as the creditors here.

III.

As here construed, and as here applied to after acquired proceeds, Commercial Code Section 9102(4) unconstitutionally deprives the creditor-vendors of this bankrupt, of their interests in property, without due process of law, contrary to the Fifth and Fourteenth Amendments to the Federal Constitution.

Summary Statement of Facts.

Briefly stated, the admitted facts are: The bankrupt was a retail merchant of boys' clothing; in July 1966 he bought an inventory of boys' clothing and retail store fixtures from appellee, giving back a note evidencing a portion of that purchase price; and, to secure that note a security agreement was signed [TR 15] giving appellee, a "purchase money security interest" in all of the inventory of boys' clothing and designated fixtures; and, in:

> "ANY AND ALL ADDITIONS, ACCESSIONS AND SUBSTITUTIONS THERETO AND THEREFOR."

A financing statement was then filed with the Secretary of State [TR 24]. It recites:

> "THIS FINANCING STATEMENT COVERS THE FOLLOWING TYPES OR ITEMS OF PROPERTY (. . .): INVENTORY OF BOYS' CLOTHING NOW AND HEREAFTER CONTAINED IN THE PREMISES."

The financing statement here filed [TR 24] expressly *does not* cover the proceeds of any collateral. As appears from its face, provisions are there made, (on the form prescribed by the Secretary of State of California (at paragraph 8 thereof)) for the secured party and debtor to declare expressly whether the "Proceeds of Collateral are also covered." This is done by so indicating by a required check mark in the box alongside the printed phrase, ("Proceeds of Collateral are also cov-

ered"). Neither the secured party, nor the debtor, so indicated upon the face of that filed financing statement [TR 24].

In the intervening four years between 1966 and 1970 (the year of the Bankruptcy) the bankrupt made substantial purchases from other vendors, now unpaid creditors herein, of different inventory than that originally sold by the Appellee. By their Stipulation of Fact, the parties agreed that only $500.00 in value of the 1966 inventory was on hand in 1970 [TR 11]. The Trustee in 1970 sold the bankrupt's inventory for more than $4,143.92 plus interest; that was the amount still owing appellee in 1970 on his 1966 indebtedness. Believing appellee to have a valid purchase money security in all the *proceeds* of that after acquired inventory, the Court below awarded the appellee the full amount of its indebtedness out of the Receivers' sales proceeds, rather than allowing appellee only the value of the remainder of the original property which appellee had first sold to the bankrupt. This Court affirmed.

ARGUMENT.

I.

The Essential Question Is Whether in This Bankruptcy Setting the Filed Financing Statement Meets, or Fails to Meet, the Standard, Imposed by Section 9402 Commercial Code, When Read in the Light of Its Purpose, and Read in the View of Sections 9102(4) and 9306 of the Commercial Code.

We are told on all sides that the most novel feature of the Uniform Commercial Code respecting secured transactions, is its substitution of a unitary security device, the filed financing statement, for the great many personal property security devices otherwise in use during the pre-commercial code years. (42 Oregon Law Review 1; 8 U.C.L.A. Law Review 806.)

Except only for this filed financing statement, there are today no other recording or notice requirements in the commercial law field. Insofar as public records are concerned only and solely by inspection of the filed financing statement can an existing or potential creditor have the opportunity to inform himself of whether, and of the extent to which, an existing or prospective debtor has encumbered his assets, and to govern himself accordingly in dealing with that debtor. (Com. Code 9407; *In re Thomas* (9 Cir.) 466 F.2d 51; *Lines v. Bank of California* (9 Cir.) 467 F.2d 1274.)

In the case at bench such a creditor inspecting this particular financing statement in 1969 or early 1970, would have learned that the financing statement covered the following types or items of property: "Inventory of boys clothing now and hereafter contained in the premises at 7644 Girard Street, LaJolla, California.", and the prospective creditor would have learned that the secured

party did *not* claim that the *proceeds* of the then or thereafter acquired inventory were covered by the Security Agreement. And he would not have learned from inspecting the financing statement itself that it granted the appellee a purchase money security interest in that inventory.

The question of the sufficiency of a filed financing statement has been before this Court in the recent cases of "*In re Thomas*" and "*Lines v. Bank of California*", *supra.* In *Lines* this Court held the failure of the financing statement to list the residence address of the debtor was inconsequential, so long as his business address was shown thereon. In *Thomas* this Court held the failure of the financing statement to show the debtor's real name, was fatal, even though the fictitious business firm name was disclosed, and even though creditors assertedly knew the debtor by that fictitious business firm name.

Here the failure on the face of the financing statement to affirmatively assert that the *proceeds* of the collateral were claimed, is surely not inconsequential. A creditor ought, with certainty, to know whether or not a secured creditor claims the proceeds of the specified collateral. If it were assumed *per se* that proceeds were always claimed, or covered, whenever personal property collateral is claimed, then there would be no reason for the elaborate provisions of Section 9306 of the Commercial Code, which define very carefully when *proceeds* are a part of the collateral itself, and when *they are not* (*cf.* subsections (1) and (2)); and define equally carefully when no right to *proceeds* of collateral exists in favor of the holder of the collateral itself (9306(3)); and, the same section 9306 specifically describes when the original rights to such *proceeds* are lost (9306(4)).

One need only glance at the following portions of Sec. 9306 to realize that the proceeds of collateral are not necessarily an inseparable adjunct of collateral; indeed even a casual glance at the following will reveal that *proceeds* are, in fact, separable and separate from the collateral: "9306 [Proceeds: Secured Party's Rights on Disposition of Collateral]:

"(3) The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected, but it ceases to be a perfected security interest and becomes unperfected 10 days after receipt of the proceeds by the debtor unless

(a) A filed financing statement covering the original collateral also covers proceeds; or

(b) The security interest in the proceeds is perfected before the expiration of the 10 day period.

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest.

(a) In identifiable noncash proceeds and in a separate bank account containing only proceeds;

(b) In identifiable cash proceeds in the form of money which is not commingled with other money or deposited in a bank account prior to the insolvency proceedings;

(c) In identifiable cash proceeds in the form of checks and the like which are not deposited in a bank account prior to the insolvency proceedings; and,

(d) In all cash and bank accounts of the debtor in which proceeds have been commingled

with other funds, but the perfected security interest under this paragraph (d) is

(i) Subject to any right of setoff; and

(ii) Limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subdivision (4)."

Nor is appellee's right, *per se,* to the proceeds of the collateral any stronger because the security agreement by its terms grants appellee a security interest in the *accessions* to the original inventory [TR 15]. The elaborate provisions in Section 9314 deal with a security interest in such accessions to goods; there in subsection (3) the legislature has provided that such a security interest in accessions to goods, *does not take priority over*

"(b) A creditor with a lien on the whole subsequently obtained by judicial proceedings."

And, of course, the Trustee in bankruptcy is that idealized hypothetical lien claimant as at the date of bankruptcy. (11 U.S.C. 110 (c); *Sequoia v. Jarret* (9 Cir.) 410 F.2d 1116, 1119; *In re Thomas, supra.*

Interesting in this regard is subsection (4) of Section 9204:

"(4) No security interest attaches under an after acquired property clause (b) to consumer

> goods other than accessions (Section 9314) or replacements when given as additional security unless the debtor acquires rights in them *within ten days* after the secured party gives value."

Surely we would reach a bizarre result here if the "after acquired" property clause of the particular security agreement made at the time of the original inventory sale in 1966, somehow attached to the consumer goods (boys' clothing) sold this bankrupt in 1969 and 1970 by other creditors.

And that a claim to collateral *does not per se carry with it a claim to the proceeds of that collateral* is made crystal clear in the study entitled "California Chattel Security and Article Nine of the Commercial Code." (8 U.C.L.A. Law Review 806, at p. 878) where we are taught that:

> "NO SUCH PERFECTED SECURITY INTEREST WILL AUTOMATICALLY ARISE AS TO PROCEEDS UNDER THE CODE UNLESS THE FILED FINANCING STATEMENT COVERING THE ORIGINAL COLLATERAL ALSO STIPULATED PROCEEDS."

It has been suggested here that a purchase money security interest in after-acquired inventory of a merchant which does not *per se* cover the proceeds of that inventory, is a "contradiction in terms". This argument, we suggest is not necessarily true. Thus a retail jewelry inventory might consist of valuable diamonds. Would it necessarily follow that an inventory lien on the *res*, would be commercially *useless*, unless the lien *per se* (and without express declaration to that effect) was construed to apply to the proceeds of those same diamonds? And what of a retail art dealer selling paintings

by Picasso or Renoir? Would not an inventory lien on that inventory be commercially useful, without reading into the purchase money security interest in the pictures, a claim to the proceeds of the sale thereof? Similar examples can be multiplied endlessly.

Nor need we speculate at all here that the parties expressly agreed by their security agreement that proceeds were intended to be covered [TR 15-20]. Instead, by their security agreement, they agreed:

> "Debtor hereby warrants and covenants:
>
> 5. *That Debtor will not sell or offer to sell or otherwise transfer the collateral* or any interest therein without the written consent of Secured Party" (no such consent is shown).

And the security agreement further provides:

> "Until default Debtor may have possession of the collateral and use it in any lawful manner not inconsistent with this agreement, and not inconsistent with any policy of insurance." [TR 17-18].

And it is expressly declared an act of default by the debtor, if the debtor sells the collateral. Thus, the Security Agreement provides:

> "Debtor shall be in default under this Agreement upon the happening of any of the following events or conditions: . . . (d) Loss, theft, destruction, *sale* or encumbrance to or of any of the collateral . . ."

With such a Security Agreement prohibiting sales of the collateral in the first instance, and declaring it to be an event of default if there were such a sale, it cannot, we submit, be said that the financing statement as filed

must be construed, *per se,* to cover proceeds of the sale of after acquired inventory. This is certainly true when, as here, the filed financing statement made no such claim to proceeds.

Perhaps, arguendo, the parties could have executed a purchase money security agreement expressly covering (subject to bankruptcy and constitutional limitations) the proceeds of sales of goods sold by third parties to the retailer; and, could have filed a financing statement expressly covering the proceeds of such after acquired goods. But the short answer here is That They Did Not Do So. What Justice Hufstedler, speaking for this Court in *DuBay v. Williams,* 417 F.2d 1277, 1288, said about a like situation where the agreement, as drawn by the parties, failed to meet the applicable legal standards, is here apposite: "*They (*i.e. the parties) *could have done so, but they did not, and we cannot draw for them an agreement they did not draw for themselves.*"

II.

The Phrase "Purchase Money Security Interest" Is Not an Esoteric Term. It Is Clearly Defined in the Commercial Code 9107. It Is Not Necessary to Read It Either Broadly or Narrowly; It Is Necessary to Read It Carefully. Since We Deal Here With the Seller of the Collateral, the Appellee, and the Purchaser, the Bankrupt, We Deal With Subsection (a) of 9107:

"9107. Definitions: 'Purchase Money Security Interest'. A security interest is a 'purchase money security interest' to the extent that it is

(a) Taken or retained by the seller of the collateral to secure all or part of its price; . . ."

Thus, by the code definition a security interest is only a "purchase money security interest" limited *to the extent* that is taken by the *seller* of the collateral to secure the price.

The principle here asserted is consistent with the note found in West's Annotation to Section 9107: "Its (i.e. the purchase money security interest) counterpart under prior California law was" the purchase money mortgage or security interest purchase money "deed of trust". *Roseleaf v. Chierighino*, 59 Cal.2d 35 and *Sosna v. Baranow*, 242 Cal.App.2d 460 make crystalline the point and the distinction here made. In *Sosana* at page 464: "The case of *Roseleaf Corp. v. Chierighino* (59 Cal.2d 35) holds that a trust deed securing a note executed by a vendee to the vendor for part of the purchase price which encumbered property other than the property purchased is not a purchase money deed of trust".

Appellee thus may have a purchase money security interest *in the goods which appellee sold to the bankrupt to secure the price. Appellee cannot have a purchase money security interest upon goods which it never sold at all to the bankrupt, but which third parties instead sold.* In the setting of this case, unless appellee was the seller of the *goods on hand* at the date of bankruptcy it could never have a purchase money security interest therein, at all.

III.

The Net Result of the Within Decision, Is to Transfer, Without Just or Any Compensation, the Interests of the General Creditors Who Sold Goods Which Were a Part of the Inventory on the Date of Bankruptcy, to One Who Was Never the Seller of Those Goods, but Who Has Nevertheless Now Been Enabled Successfully to Claim the Rights of Such a Seller. That Result Is the Direct Consequence of the Present Application and Construction of Commercial Code Sections 9107(a) and 9102(4).

Such a result is contrary both to the Fifth and Fourteenth Amendments to the Federal Constitution, and particularly to the due process and equal protection of the law clauses thereof.

Since the construction and application here made of these Statutes collide so patently with these Federal guarantees, and since the construction and application of these Statutes suggested here by Appellant avoid such constitutional collision, the latter construction ought to be followed. (*American Power and Light v. S.E.C.*, 329 U.S. 90, 107, 8; *City of Los Angeles v. Belgrade*, 42 Cal.2d 823, 832.)

A rehearing is requested.

LUCE, FORWARD, HAMILTON & SCRIPPS,
GITELSON, KATZ, HOYT & BELL,
By CHARLES J. KATZ,
Attorneys for Appellant-Petitioner Herein.

I, Charles J. Katz, attorney for Appellant-Petitioner do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for purpose of delay.

CHARLES J. KATZ,
Attorney for Appellant-Petitioner.

CERTIORARI DENIED